

# Joint Economic Committee WEEKLY ECONOMIC DIGEST

Senator Charles E. Schumer, Chairman  
Congresswoman Carolyn B. Maloney, Vice Chair

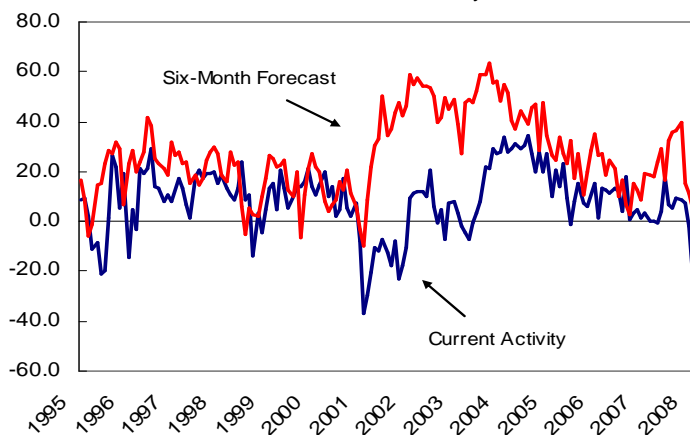
February 25, 2008

## ECONOMIC NEWS

### Signs of Economic Weakness Persist

Regional manufacturing activity continued to weaken in February, according to firms polled for the Philadelphia Fed's *Business Outlook Survey*. The Philadelphia Fed's February survey of manufacturing firms in the Third Federal Reserve District indicated weakening activity in the sector. After falling significantly last month, indexes for general activity, shipments, and new orders remained negative. Manufacturers' outlook for the next six months turned noticeably more pessimistic this month, with some future indicators turning negative for the first time since 2001. (See Chart)

Philadelphia Fed Survey of Business Outlook  
Current and Future General Activity Indexes



Source: Federal Reserve Bank of Philadelphia.

**Rising food and energy prices boosted overall consumer prices, but core inflation held steady in January.** The seasonally adjusted core consumer price index (Core CPI), which excludes changes in the volatile prices of food and energy, increased by 0.3 percent last month, following a 0.2 percent increase in December 2007. CPI-U, the overall CPI for all urban consumers increased 0.4 percent last month, following a 0.4 percent increase in December. The prices consumers pay for energy and food both rose by 0.7 percent last month. Over the past 12 months, the overall CPI has risen by 4.4 percent and the core CPI by 2.5 percent.

**New homebuilding remains weak.** The number of building permits for privately-owned housing units fell by 3.0 percent last month to 1.048 million units at a seasonally adjusted annual rate. The number of January 2008 building permits was 33.1 percent lower than the revised January 2007 estimate. Housing starts in January were slightly higher than December 2007, but were 27.9 percent below starts in January 2007.

## IN FOCUS

### The Credit Crunch Migrates to Main Street

The credit crunch that began in July of last year has migrated from Wall Street to Main Street. Chaos in the market for auction rate bonds (ARBs) has resulted in unexpectedly high interest costs for municipalities and other agencies that used these securities to finance their debt. As a consequence, many cities will be forced to find alternative forms of finance.

ARBs are slightly exotic financial instruments. The rates paid to bondholders are reset at periodic auctions, usually held at intervals of one to five weeks. The auctions are run by banks and investment banks that act as dealers. When dealers are unable to obtain bids for a resetting bond, the interest rate automatically resets to a penalty rate that is determined in the bond contract.

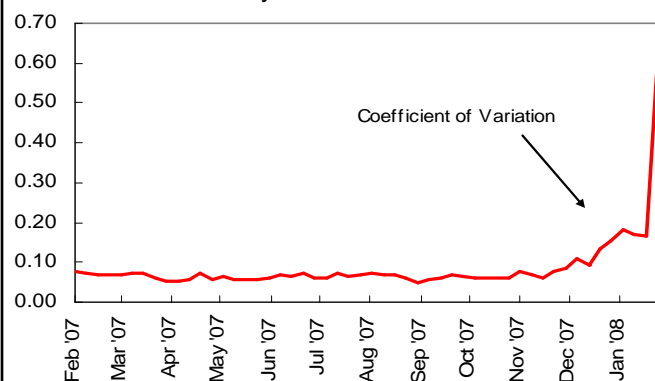
Municipalities were attracted to the ARB market by cost considerations. When the ARB market was functioning smoothly, they could finance long term debt at rates below those paid on fixed rate bonds. Buyers of municipal ARBs, primarily institutions and high net worth individuals, were attracted by highly-rated, liquid assets paying attractive short term interest rates.

The market for municipal ARBs began to come apart in February. Auctions for hundreds of resetting bonds have "failed" because there were no bidders. The dealers decided not to support the market. Interest rates on some of the failed bonds reset to very high penalty rates. For exam-

*Continued on reverse...*

## SNAPSHOT

Auction Rate Volatility Rises with Bond Insurance Crisis



Source: Securities Industry and Financial Markets Association 7-Day Tax Exempt Index for auction rate securities, available at [http://www.sifma.org/capital\\_markets/arsindex.shtml](http://www.sifma.org/capital_markets/arsindex.shtml). This index may include some derivatives based on tax exempt securities.

# Joint Economic Committee WEEKLY ECONOMIC DIGEST

## THE WEEK AHEAD

DAY	RELEASE
Monday, Feb 25	Existing Home Sales (January 2008)
Tuesday, Feb 26	Consumer Confidence (February 2008)
Wednesday, Feb 27	New Home Sales (January 2008) Durable Orders (January 2008)
Thursday, Feb 28	<b>JEC Hearing — The Total Economic Costs of the Iraq War Beyond the Federal Budget, Room 106, Dirksen Senate Office Building, 9:30 a.m.</b> Gross Domestic Product (Fourth Quarter 2007, Preliminary)
Friday, Feb 29	Core Personal Consumption Expenditure Index (January 2008)

*Thursday  
Feb 28th:  
JEC Hearing on  
the Total  
Economic  
Costs of the  
Iraq War*

## THE ECONOMY AT A GLANCE

KEY INDICATORS	MONTH			QUARTER			YEAR	
	Jan	Dec	Nov	2007 Q4	2007 Q3	2007 Q2	2007	2006
Real GDP Growth (%)	—	—	—	0.6	4.9	3.8	2.2	2.9
Unemployment (% of labor force)	4.9	5.0	4.7	4.8	4.7	4.5	4.6	4.6
Labor Productivity Growth (%)	—	—	—	1.8	6.0	2.2	1.6	1.0
Labor Compensation Growth (%)	—	—	—	3.4	3.1	3.5	3.4	3.1
CPI-U Inflation (%)	4.9	4.9	11.4	5.0	2.8	4.6	2.9	3.2
Core CPI-U Inflation (%)	3.7	2.4	2.4	2.5	2.5	2.0	2.3	2.5

Sources: Bureau of Economic Analysis, U.S. Department of Commerce; Bureau of Labor Statistics, U.S. Department of Labor.

Notes: Except where otherwise noted, values in the table represent percent changes at seasonally adjusted annual rates. Productivity is output per hour worked in private nonfarm businesses. The Employment Cost Index is for civilian workers in government and business. Core CPI-U inflation is the percent change in the CPI-U excluding food and energy as reported by the Bureau of Labor Statistics. The designation "n.a." denotes that data are not yet available.

## IN FOCUS (Continued)

ple, the interest rate on some New York Port Authority bonds reset to 20 percent. For other ARBs, the resets were much lower, which left those bondholders with low interest rate securities that no one was willing to purchase.

This widespread disorder is new, but signs of difficulty in this market have been visible for some months. The interest rates for municipal ARBs vary over time, along with other short term rates. But the coefficient of variation for these rates, which measures the dispersion of rates around their average value, has been very steady historically, indicating that interest rate resets are not often extreme. This pattern changed at the end of 2007. (See Snapshot) The coefficient of variation, calculated from data from the Securities Industry and Financial Markets Association, began to rise in 2007 and has moved up sharply since then, as a greater fraction of ARBs reset at relatively high rates.

Increased volatility, followed by market implosion, is most likely a consequence of the ongoing credit crisis. Buyers may have panicked because municipal ARBs are guaranteed by the monoline bond insurers, whose credit ratings and solvency are suspect because of subprime exposure. The banks and investment banks who act as dealers have experienced losses of their own, and therefore have no desire to add unmarketable securities to their balance sheets.

The result of this chaos is financial stress for municipal borrowers. The bond issuers who experienced high default resets will try to find other ways to finance their debt. Their options may be limited and costly, given the overall state of financial markets.